7/27/81

Financial Markets

Irving Trust

Irving Trust Company
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New York, NY 10015

Economic Research & Planning Division

Friday
(Noon)

July 17, 1981

Financial markets had an extremely nervous tone this week as participants waited for a clear confirmation--in the form of a lower Federal funds rate--that the Federal Reserve has eased pressure on bank reserves positions. Also weighing on market sentiment were concerns that the money stock data to be reported Friday night for the week ended July 8 might show a large increase in M-1B.

While data on bank reserves positions make clear that the Fed has eased its policy stance, the crucial question for market participants is: how much? Currently, it appears that the reduction in pressure on bank reserves positions should suffice to put the funds rate somewhat under 18%--a rate that would still be rather high by historical standards.

At this juncture, the Fed faces several problems with regard to its monetary aggregates targets. The most glaringly evident is the inconsistency of the M-1B and M-2 targets--M-1B (shift-adjusted or otherwise) is under the bottom of its target range, while M-2 is at the top of its range. In principle, the inconsistency is easily corrected by adjusting one or both of the targets, but political realities make that course difficult. In addition, the Fed is concerned about the prospect of a speedup in economic activity late in the year, causing the targets to be missed again this year as they were (technically) last year. A highly restrictive policy now buys insurance against such an eventuality later, and the best bet is that the Fed will gradually continue its easing moves between now and year-end as the likelihood of a late surge in money growth recedes.

According to one report, the FOMC decided at its July 8 meeting to leave the annual targets for M-1B and M-2 unchanged but to aim for the bottom edge of the M-1B target, rather than the midpoint, as is customary. Our view is that this approach--if actually confirmed by Chairman Volcker's testimony to Congress next Tuesday--would represent only a pragmatic attempt to resolve the target inconsistency problem while minimizing political controversy. Moreover, since M-1B remains below its target range, even the new approach would leave room for future moves toward ease by the Fed.

The real problem for market participants, however, is that current rates on many money market instruments <u>already</u> have discounted a near-term decline of the Federal funds rate. For example, 90-day Treasury bills currently yield about 15%, while the RP rate is slightly over 17%. That relationship suggests that at least some market participants are expecting that within the next three months the RP rate will decline to well under 15%, which would require a drop in the funds rate on the order of several points. Though the funds rate has indeed been declining lately and appears likely to continue to do so, the slowness of the declines may well prompt some near-term back-ups of rates on other money market instruments.

William C. Melton

Note: The full text of this letter is available to Telerate subscribers on pages 7250-51 on the Monday morning following the Friday date of the letter.

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Market Data

	7/17/81 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	20.50%	20.50%	11.50%
Effective since	7/8/81		
Discount Rate at Federal Reserve Bank	14.00	14.00	11.00
Federal Funds	17.75	19.25	8.75
Repurchase Agreements	17.25	18.75	8.13
U.S. Treasury Issues			
Bills			
3 months	14.85	15.64	8.20
6 months	15.36	15.78	8.40
1 year	15.59	15.35	8.50
Coupons			
2 years	14.95	14.94	8.95
4 years	14.59	14.55	9.22
7 years	14.24	14.01	9.65
10 years	14.03	13.94	10.12
Long Bond	13.35	13.26	10.12
Negotiable Certificates of Deposit-Secondary Market			
1 month	17.65	18.50	8.65
3 months	17.45	17.85	8.65
6 months	17.15	17.35	8.70
1 year	16.50	16.50	9.00
Banker's Acceptances			
1 month	17.50	18.50	8.60
3 months	17.60	17.80	8.55
6 months	17.40	17.30	8.65
Eurodollar Deposits			
1 month	18.44	19.19	9.00
2 months	18.38	18.75	9.13
3 months	18.44	18.56	9.25
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	17.38	17.00	6.00
1 month	17.00	17.75	8.38
3 months	16.75	16.75	8.38
Bank Holding Companies			
1 month	17.25	18.00	8.50
Dealer Placed:			
3 months	17.00	NA	8.38
New AA Corporate Utility Bond	16.35	15.88	11.75
Tax Exempt			
6 month Project Notes	7.75	7.60	4.70
1 year AAA Bond	7.80	7.75	5.00
5 year AAA Bond	8.70	8.40	5.30
20 year AAA Bond	10.20	10.20	7.40

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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